# China and Greece – Here We Go, Again

As the November Presidential elections approach, the United States is looking more like a populist playground, with each passing day. Among other noxious things, China-bashing has become even more fashionable. When it comes to China, the three top Republican contenders for the nomination to challenge President Obama (Mitt Romney, Rick Santorum and Newt Gingrich) have gotten way out in the protectionist, trade-war and currency-war weeds. Ron Paul has avoided that economic brier patch by embracing free trade principles. President Obama is, of course, right in the middle of the brier patch.

To keep the potential Republican challengers at bay, the President is shooting real bullets. Indeed, he recently stepped before the cameras in the White House Rose Garden and announced that the United States was lodging a formal "request for consultation" with China at the World Trade Organization. The issue is China's control and alleged hoarding of rare earth minerals. Although these so-called consultations (in which the European Union and Japan will join the U.S.) do not constitute a legal case against China, they are a first, important step.

Contrary to recent political polls, which suggest that the President's approval ratings are sagging, the predictions market Intrade (where participants put their own money at risk and the resulting prices are objective indicators of value) scores the President's chance of victory in November at 60.7%. This is a rather formidable edge and is up from 59.9%, which I reported in my March column. So, the President's populist, hard-ball moves vis-à-vis China have "worked," if that's the right word.

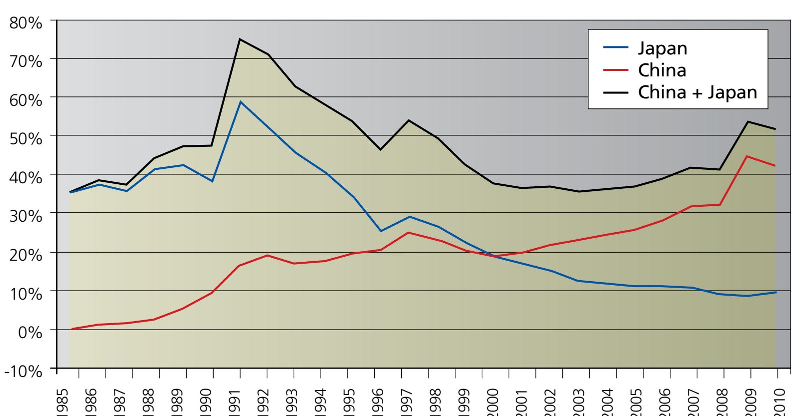
But, let's step back and take a look at Washington's embrace of mercantilist machismo. The United States has recorded a trade deficit in each year since 1975. This is not surprising because savings in the U.S. have been less than investment. The trade deficit can be reduced by some combination of lower government consumption, lower private consumption or lower private domestic investment. But, you wouldn't know it from listening to the rhetoric coming out of Washington.

This is unfortunate. A reduction of the trade deficit should not even be a primary objective of federal policy. Never mind. Washington seems to thrive on counter-productive trade and currency wars that damage both the U.S. and its trading partners.

From the early 1970s until 1995, Japan was an enemy. The mercantilists in Washington asserted that unfair Japanese trading practices caused the U.S. trade deficit and that the U.S. bilateral trade deficit with Japan could be reduced if the yen appreciated against the dollar – a "weak dollar policy.

Washington even tried to convince Tokyo

**Percent Contribution to U.S. Trade Deficit**




*Sources: U.S. Bureau of Economic Analysis and Author's Calculations.*

## by Steve Hanke

### China – Exchange-Rate Flexibility vs. Fixity

| | Exchange Rate (CNY per USD) | | | Inflation | | | GDP | | |
|---|---|---|---|---|---|---|---|---|---|
| | Average | Min | Max | Average | Min | Max | Average | Min | Max |
| 1980-1994 | 3.80 | 1.50 | 8.62 | 8.42% | 1.50% | 24.10% | 10.13% | 3.80% | 15.20% |
| 1995-2004 | 8.29 | 8.28 | 8.35 | 3.14% | -1.40% | 17.10% | 9.15% | 7.60% | 10.93% |
| 2005-2008 | 7.68 | 6.95 | 8.19 | 3.49% | 1.47% | 5.90% | 11.95% | 9.60% | 14.20% |
| 2009-2010 | 6.80 | 6.77 | 6.83 | 1.32% | -0.68% | 3.33% | 9.77% | 9.22% | 10.33% |
| 2011 | 6.46 | | | 5.50% | | | 9.47% | | |

*Sources: International Monetary Fund, World Economic Outlook, September 2011 and International Monetary Fund, International Financial Statistics, March 2012.*

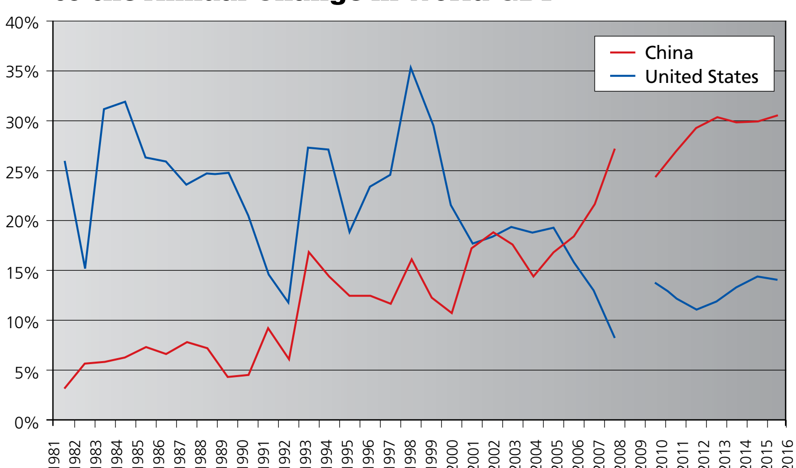
that an ever-appreciating yen would be good for Japan. Unfortunately, the Japanese complied and the yen appreciated, moving from 360 to the greenback in 1971 to 80 in 1995. Today, it's 84.

In April 1995, Secretary of the Treasury Robert Rubin belatedly realized that the yen's great appreciation was causing the Japanese economy to sink into a deflationary quagmire. In consequence, the U.S. stopped arm-twisting the Japanese government about the value of the yen and Secretary Rubin began to evoke his now-famous strong-dollar mantra.

But, while this policy switch was welcomed, it was too late. Even today, Japan continues to suffer from the mess created by the yen's appreciation.

As Japan's economy stagnated, its contribution to the increasing U.S. trade deficit declined, falling from its 1991 peak of almost 60% to 9.5% in 2010 (see the accompanying chart).

### Percent Contribution to the Annual Change in World GDP




*Sources: International Monetary Fund, World Economic Outlook, September 2011 and Author's Calculations.*
*Note: The 2009 data points are removed because of the distortion caused by the global recession.*

While Japan's contribution declined, China's surged from slightly more than 9% in 1990 to 42% in 2010. With these trends, the Chinese yuan replaced the Japanese yen as the mercantilists' whipping boy.

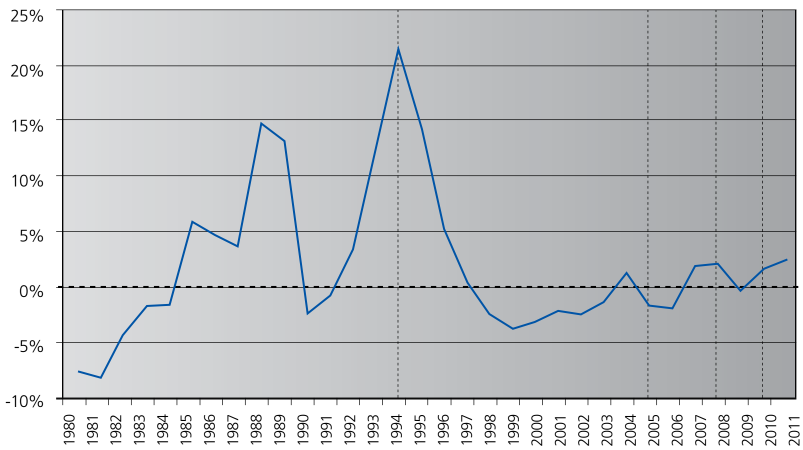
Interestingly, the combined Japanese-Chinese contribution has actually declined from its 1991 peak of over 70% to only about 50% in 2010. This hasn't stopped the mercantilists from claiming that the Chinese yuan is grossly undervalued, and that this creates unfair Chinese competition and a U.S. bilateral trade deficit with China.

I was introduced to the Chinese currency controversy almost ten years ago, when I appeared as a witness before the U.S. Senate Banking Committee on May 1, 2002. The purpose of those hearings was to determine, among other things, whether China was manipulating its exchange rate.

United States law requires the U.S. Treasury Department, in consultation with the International Monetary Fund, to report bi-yearly as to whether countries – like China – are gaining an "unfair" competitive advantage in international trade by manipulating their currencies.

The U.S. Treasury failed to name China a currency manipulator back in May 2002, and it hasn't done so since then. This isn't too surprising since the term "currency manipulation" is hard to define. Accordingly, it is not an operational concept that can be used for economic analysis.

**Difference Between Chinese and U.S. Inflation Rates**




*Source: International Monetary Fund, World Economic Outlook, September 2011.*

Even the U.S. Treasury has acknowledged this fact. But, this has not stopped politicians and special interest groups in the United States, and elsewhere, from asserting that China manipulates the yuan.

Protectionists in the U.S. have threatened to impose tariffs on imported Chinese goods if Beijing does not dramatically appreciate the yuan. These protectionists even claim that China would be much better off if it allowed the yuan to become stronger vis-à-vis the U.S. dollar.

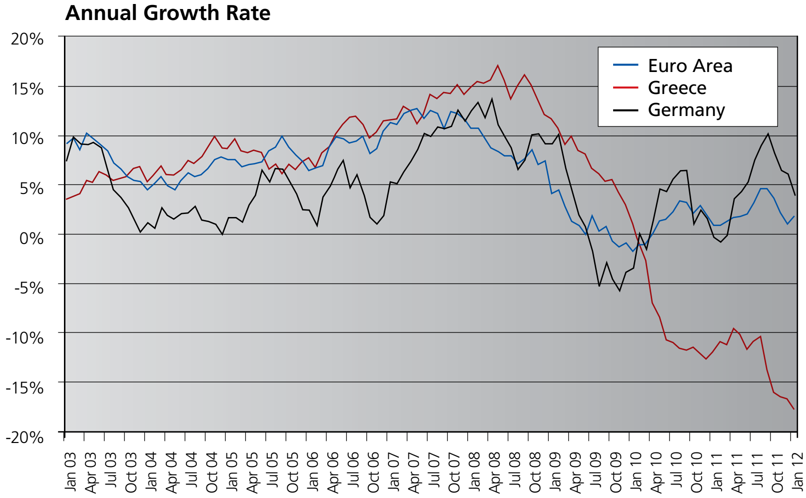
This is, of course, nonsense. China has experimented with different exchange-rate regimes. Until 1994, the yuan was in an ever-depreciating phase against the U.S. dollar. Relatively high volatile readings for China's GDP growth and inflation rate were encountered during this phase (see the accompanying table). After the maxi yuan depreciation of 1994 and until 2005, exchange-rate fixity was the order of the day, with little movement in the CNY/USD rate. In consequence, the volatility of China's GDP and inflation rate declined, and with the yuan firmly anchored to the U.S. dollar, China's inflation rates began to shadow those in America (see the accompanying chart). Then, China entered a gradual yuan appreciation phase (when the CNY/USD rate declined in the 2005-08 period). Without a firm dollar anchor, China's inflation rate picked up, relative to the U.S. inflation rate. And, yes, the volatility of China's GDP picked up and China's average inflation rate rose, too. During the international crisis period of 2009-10, China reverted to exchange-rate fixity, resulting in stability.

Like Karl Schiller, the German Finance Minister (1966-72), the Chinese leadership embraces stability. Or, as Schiller pithily put it: "Stability is not everything, but without stability, everyone is nothing." Unfortunately, populism is selling in Washington. We can expect increasing Washington-Beijing trade and currency tensions for the remainder of the year and their continuation for the foreseeable future.

This state of affairs could be dangerous, not only for the Chinese, but also for the world economy. Instability and economic troubles in China prompted by protectionist passions could throw a monkey wrench into the world's new growth locomotive: China (see the accompanying chart).

And if you think the political chattering classes in the U.S. are dangerous, take a look at Europe, where the elites are fighting economic reality with all their might – a fight they will lose. Indeed, they have built an economic doomsday machine. And when it comes to Greece, don't fool yourselves into believing that the recent huge debt restructuring exercise will allow Europe's politicos to pull their chestnuts out of the fire. Greece's annual broad money (M3) growth rate has been in negative territory for every month since February 2010, and it is currently contracting at a fantastic 17.5% (see the accompanying chart). In the words of former President George W. Bush (not Yogi Berra): "This sucker is going down." You can forget all the calculations and soothing noises coming from Europe.

**U.S. Broad Money (M3)**
**Annual Growth Rate**




*Sources: Bundesbank and the Bank of Greece.*

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